No. 20,841

IN THE

United States Court of Appeals

For the Ninth Circuit

In the Matter of
DESERT DIET DEVELOPMENT CORPORATION,
Debtor.

DESERT DIET DEVELOPMENT CORPORATION,
Appellant,

vs.

CHARLES W. HERBERT, WALTER T. MOLL, and MELVIN HELLWITZ,
Appellees.

On Appeal from the United States District Court for the District of Arizona

OPENING BRIEF FOR APPELLANT

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JURISDICTIONAL STATEMENT

This is an appeal from an order entered November 10, 1965, by the United States District Court for the District of Arizona. This appeal is brought under the jurisdiction established by Section 24 of the Bankruptcy Act, 11 U.S.C.A., paragraph 47, and Section 121 of the Bankruptcy Act, 11 U.S.C.A. 521.

INTRODUCTION

For the sake of brevity, Desert Diet Development Corporation will hereinafter be referred to as the

"Debtor", and Charles W. Herbert, Walter T. Moll, and Melvin Hellwitz will be referred to collectively as the "Petitioners".

The Transcript of Record will be designated "T.R.", and the Reporter's Transcript will be designated "R.T."

STATEMENT OF THE CASE

This case is concerned with the order of the Referee in Bankruptcy, affirmed by the United States District Judge, which order approved a debtor's petition for an involuntary reorganization of the Debtor corporation under Chapter X of the United States Bankruptcy Act.

It is the contention of the Appellant that the involuntary petition and the facts as presented in the hearings do not entitle the Petitioners to the relief prayed for in their petition, and that the order approving the petition is a misapplication of Chapter X of the Bankruptcy Act.

FACTS OF THIS CASE

Desert Diet Development Corporation is a corporation organized under the laws of the State of Florida, licensed to carry on business in the State of Arizona.

Each of the three Petitioners is a creditor of said corporation who has a claim against the corporation or its property and each of said claims is liquidated as to amount and not contingent as to liability, which

claims arise from the sale of land to the Petitioners. The claims of the said Petitioners amount in the aggregate to more than $5,000.00.

The unsecured debts of the Debtor total approximately $567,000.00. The secured debts total approximately $174,000.00, giving a total corporate debt of approximately $741,000.00. Approximately $300,000.00 of this indebtedness shown above as unsecured indebtedness arises from the sale of lots, and a substantial proportion of this indebtedness could be satisfied by the conveyance of the lots.

The assets of the corporation consist of real property, accounts receivable due to the corporation pursuant to contracts for the sale of lots, engineering expenses and development costs. As raw land, the land of the corporation has a value of from $300 to $600 per acre. From all of the evidence in the case, it appears that the land as raw land has a probable value of approximately $500 per acre. A great deal of the engineering work has been completed with respect to the subdividing of certain lands, and, not including lands which are the subject of existing contracts for sale, there are more than 2,750 lots available for development and sale. These lots have a reasonable prospect of development and sale, which according to conservative estimates as to development costs and sales promotion, should yield a net return of at least $400 per lot.

The Debtor corporation is and was at the time of the filing of the original petition herein unable to meet its debts as they mature.

That a proceeding to foreclose a mortgage against all or the greater portion of the property of the Debtor corporation is now pending in the Superior Court of Santa Cruz County, Arizona, said proceeding being Civil Action No. 5584 in that Court. The Petitioners are members of a syndicate group which holds the mortgage after purchasing it from a third party.

The balance sheet of the corporation dated May 1, 1963, Exhibit 14 in evidence, does not indicate how many shares of capital stock, if any, have been issued. There are three stockholders in the corporation. (See page 3, paragraph 8 of verified answer, T.R. page 15, Vol. 1.)

Members of the syndicate which holds the mortgage have agreed to subordinate the first mortgage and to issue deeds to lot purchasers. That since the filing of the petition the Debtor corporation has delivered to the Court-appointed trustee deeds to all property purchased, not only by the three Petitioners, but by the approximately two hundred other persons purchasing lots in Buena Vista.

The assets of the corporation have a value exceeding the liabilities of the corporation, and if the affairs of the corporation were managed and administered on a businesslike basis, there is a fair prospect that the corporation could pay its debts and realize a profit for its investors.

The following are proceedings now pending affecting the property of the corporation:

(a) There is now pending against the corporation a suit for the foreclosure of a first mort-

gage upon all of its land, said suit being Civil Action No. 5584 in the Superior Court of Santa Cruz County, Arizona.

(b) There is now pending a class action for declaratory judgment filed by five syndicate investors on behalf of all the syndicate investors seeking a declaration of the rights of the syndicate investors and seeking to have the assets of the corporation applied to the discharge of the debts of the corporation and the profits, if any, from the operation distributed in accordance with law. Said civil action is Action No. 5708 now pending in the Superior Court of Santa Cruz County, Arizona.

There is no pending plan of reorganization, readjustment, or liquidation affecting the property of the corporation, either in connection with or without any judicial proceedings.

STATUTES INVOLVED

United States Bankruptcy Act: Sections 130(7), 141, 143, 145, and 146(2).

SPECIFICATION OF ERRORS RELIED UPON

The Court erred in its application of Chapter X of the Bankruptcy Act in two instances; namely, (1) "Adequate relief" is available under Chapter XI of the Bankruptcy Act, and (2) the corporate structure of the Debtor and the classification of the credi-

tors is simple, and there should be no reason for an alteration of the relationship of the creditors to the Debtor.

QUESTIONS PRESENTED

1. Does a mortgage foreclosure as joined in by the Petitioners, a suit for declaratory relief and accounting joined in by the Petitioners, and the delivery of deeds by the Debtor to all purchasers, and the rights of the Debtor under Chapter XI provide "adequate relief" to the Petitioners, and therefore demand proof before the Referee of a type and nature not submitted to the Referee in this case?

2. Does a corporation with three stockholders, $567,000.00 in unsecured debts ($300,000.00 of which has been satisfied by the delivery of deeds), a $150,000.00 first mortgage, and $300,000.00 in syndicate holders meet the sophisticated requirements for a Chapter X Arrangement?

ARGUMENT I

The Referee in Bankruptcy in Finding of Fact No. 13, page 5 of the "Report of Special Master on Issues", R.T. Volume I, page 45, and further in Conclusion of Law No. 3, states: "The Petitioners do not have adequate relief." These findings were confirmed by the District Judge without additional comment.

First, the Referee states that the mortgage foreclosure did not give adequate relief as it would

destroy the rights of "creditors" and "investors". The missing consideration is obvious. The mortgage is owned in part by the Petitioners. T.R. Volume 3, page 99. (Also see Petitioners' Exhibit No. 8.) The syndicate investors are also holders of the mortgage and are also Petitioners. Secondly, the Court states that the suit for declaratory relief can give no adequate relief to Petitioners as "creditors". The Petitioners are "creditors" because they purchased property from the Debtor corporation.

The deeds to these properties have been delivered to the Trustee on October 8, 1965. The record shows that as creditors this extinguishes the claim of the Petitioners, and full relief has been given to them.

The issue of adequate relief has been discussed extensively in many cases and in *Law Review* articles. Ordinarily this applies to an argument between relief under Chapter X and Chapter XI of the Bankruptcy Act where the debtor or certain of its creditors have requested relief under Chapter XI, and other creditors, but not the debtor, have sought relief under Chapter X.

It is submitted that the basis of this argument is that even though the Debtor in this case has not requested relief under Chapter XI of the Bankruptcy Act, that the same tests and requisites of proof apply to the petition of the three creditors in this case before the remedies of Chapter X can be available.

On the Debtor's motion to dismiss the involuntary petition, the question is not whether the items of ade-

quate relief was properly pleaded by the Petitioners, but whether the Petitioners proved that they needed the use of Chapter X to give them "adequate relief". *In re Philadelphia Rapid Transit Company,* District Court of Pennsylvania, 8 F. Supp. 51.

The *Journal of the National Conference of Referees in Bankruptcy,* January, 1956, contains an extensive article on the conflict between Chapter X and Chapter XI of the Bankruptcy Act where competing petitions were before the Court. This article discusses *In re General Stores Corporation,* 129 F. Supp. 801, aff'd 222 F. 2d 234 (2d Cir. 1955), 76 S.Ct. 516; *In re Transvision, Inc.,* 119 F. Supp. 134, aff'd 217 F. 2d 243 (2d Cir. 1954); and, *Securities and Exchange Commission v. United States Realty and Improvement Co.,* 310 U.S. 434 (1940), reversing 108 F. 2d 794.

In the *General Stores* case and the *United States Realty* case, *supra,* the Supreme Court issues a clear mandate for a case-by-case approach, and states conclusively that there are no absolute rules for the Court to use in determining whether Chapter X of the Bankruptcy Act is applicable to a corporate reorganization.

See *Securities and Exchange Commission v. American Trailer Rentals Co.,* 85 S.Ct. 513, 379 U.S. 594 (1965) at (5). This case states:

> "In enacting these two distinct methods of corporate rehabilitations, Congress has made it quite clear that Chapters X and XI are not alternate routes, the choice of which is in the hands

> of the debtor. Rather, they are legally, mutually exclusive paths to attempted financial rehabilitation. A Chapter X petition may not be filed unless 'adequate relief' is not obtainable under Chapter XI, § 146(2). Likewise, a Chapter XI petition is to be dismissed, or in effect transferred, if the proceedings 'should have been brought' under Chapter X, § 328."

In the *Transvision* case, *supra,* at page 246, the Court states that the Bankruptcy Act "Manifests a conscious purpose of Congress to encourage resort to Chapter XI whenever the remedy afforded thereby adequately protects the interests involved."

It is respectfully submitted that the Court below erred when it allowed the petition for a Chapter X Arrangement, because "adequate relief" is available under Chapter XI.

ARGUMENT II

It is the contention of the Appellant, Desert Diet Development Corporation, that Chapter X of the Bankruptcy Act should not be applied to the corporation as the remedy is too drastic, and that the corporation is simply composed with only three stockholders, and that it was never the intention of Congress or the Bankruptcy Act to attempt to reorganize under Chapter X such a simple corporation.

The cases referred to in Argument I discuss generally the types of corporation Chapter X should be applied to. The following authority is presented in support of the Appellant's position.

In *Securities and Exchange Commission v. American Trailer Rentals Co.,* 85 S.Ct. 513, 379 U.S. 594 (1965), the Court discusses the type of corporation to which Chapter X applies. The Court states at page 521 that

> "The one [Chapter X] adapted to the reorganization of corporations with complicated debt structures and many stockholders, the other [Chapter XI] to composition of debts of small individual businesses and corporations with few stockholders".

This citation is from the *United States Realty* case and it was cited with approval where the Court continued that the *United States Realty* case stated that Chapter X is best used where there is a publicly held corporation. This is not the case in Desert Diet Development Corporation with only three stockholders.

Securities and Exchange Commission v. American Trailer Rentals Co., 85 S.Ct. 513, 379 U.S. 594 (1965) at page 522:

> "The Court stated:
>
> > 'It may well be that in most cases where the debtor's securities are publicly held c. X will afford the more appropriate remedy. But that is not necessarily so. A large company with publicly held securities may have as much need for a simple composition of unsecured debts as a smaller company. And there is no reason we can see why c. XI may not serve that end. The essential difference is not between the small company and the large company but between the needs to be served.' 350 U.S. at 466, 76 S.Ct. at 519.

> "The Court pointed out that the 'needs to be served' included such factors as requirements of fairness to public debt holders, need for a trustee's evaluation of an accounting from management or determination that new management is necessary, and the need to readjust a complicated debt structure requiring more than a simple composition of unsecured debt. Id., at 466-467, 76 S.Ct. at 519."

In the case of *Securities and Exchange Commission v. Crumpton Builders, Inc.,* 337 F. 2d 907 at page 909, the Court states:

> "The jurisdictional scope of Chapters X and XI, both enacted as part of the 1938 Chandler Amendment to the Bankruptcy Act, has perplexed lawyers and judges. Chapter X seems appropriate for a giant corporation with a complex debt and equity structure or for a corporation in dire need of new capital or management; Chapter XI seems appropriate for a small closely held corporation to settle with its trade creditors. But there was no formula in the statute and no guideline in the legislative history."

The Appellant realizes that the cases cited call for a case-by-case decision and that the six leading cases are somewhat confusing as to what type of corporation Chapter X should be applied to. *In re Herold Radio & Electronics Corporation,* 191 F. Supp. 780 at page 784, states:

> "In the following cases, Chapter X was preferred to Chapter XI: General Stores Corp. v. Shlensky, supra; Securities and Exchange Com-

mission v. United States Realty & Improvement Co., supra; Securities and Exchange Commission v. Liberty Baking Corporation, supra.

In the following cases, Chapter XI was preferred to Chapter X: Securities and Exchange Commission v. Wilcox-Gay Corp., 6 Cir., 1956, 231 F.2d 859; In Re Transvision, Inc., supra; In re Lea Fabrics, Inc., supra.

The surface alignment of the six leading decisions becomes plastic in the hands of those who, by a process of selective emphasis that disregards context, find statements in the opinions and facts in the records that seemingly can be moulded to fit either side of rival arguments in a particular case.

In reality, these decisions form an harmonious body of law. They suggest a common thesis and a common approach.

In United States Realty & Imp. Co., supra, the Court concluded that the petition for an arrangement of unsecured debts under Chapter XI should be dismissed because the relief obtainable under that chapter was inadequate. The legislative history and the respective policies, purposes and operational procedures of the two chapters were compared and contrasted in Mr. Justice Stone's opinion.

In that case (310 U.S. at page 456, 60 S.Ct. at page 1053), the circumstances were 'such as to raise a serious question whether any fair and equitable arrangement in the best interest of creditors can be effected without some rearrangement of its capital structure.' The Court pointed out (310 U.S. at page 456, 60 S.Ct. at page 1053)

that a Chapter X proceeding would permit an inquiry into the debtor's 'financial condition and practices and its business prospects * * * without which there is at least danger that any adjustment of its indebtedness will not be just and equitable, and that its revived financial life will be too short to serve any public or private interest other than that of respondent [the debtor].'

In General Stores Corp. v. Shlensky, supra, the Court decided that proceedings under Chapter X rather than Chapter XI were appropriate. The Court's opinion (per Mr. Justice Douglas) pointed out (350 U.S. at page 466, 76 S.Ct. at page 519):

> 'The character of the debtor is not the controlling consideration in a choice between c. X and c. XI. Nor is the nature of the capital structure. * * * The essential difference is not between the small company and the large company but between the needs to be served.
>
> 'Readjustment of all or a part of the debts of an insolvent company without sacrifice by the stockholders may violate the fundamental principle of a fair and equitable plan * * * as the United States Realty Co. case emphasizes.
>
> 'Readjustment of the debt structure of a company without more may be inadequate unless there is also an accounting by the management for misdeeds which caused the debacle.
>
> 'Readjustment of the debts may be a minor problem compared with the need for new management. Without a new management today's readjustment may be a temporary moratorium before a major collapse.

'These are typical instances where c. X affords a more adequate remedy than c. XI.'

In Securities and Exchange Commission v. Liberty Baking Corporation, supra, the Court concluded (240 F.2d 516) that there were 'important features which call for the application of Chapter X,' rather than Chapter XI. Judge Frank, writing for the Court of Appeals, pointed out (240 F.2d 514):

'The proposed arrangement is for more than a "simple composition" of creditors. Not only is considerable amount of Liberty's debentures held by public investors, but the arrangement would seriously disturb their rights.'

The Court also adverted (240 F.2d 515) to 'a grave question whether the plan would deprive creditors of their "absolute priority" rights as against stockholders,' and to the need for determing whether 'a change of management is essential.'

At page 516 of 240 F.2d, footnote 10, Judge Frank distinguished Securities and Exchange Commission v. Wilcox-Gay Corp., supra, and In Re Transvision, Inc., supra, in the following discussion:

'In S.E.C. v. Wilcox-Gay Corp., 6 Cir., 231 F.2d 859, it is true that the court, referring to the Supreme Court's decision in General Stores, upheld the exercise of the District Court's discretion to permit Chapter XI proceedings. But there the facts were considerably different from those in the instant case: (1) The debtor had previously undergone Chapter X proceedings, and, following rather extensive investigation of

its affairs in those proceedings, was permitted to go into Chapter XI proceedings after the secured creditors' claims were met in full. (2) The debenture holders (who held securities of about $220,000) received interest payments on their claims, and apparently only general (trade) creditors were included in the scaling down to 50% of their claims. (3) The court rested its decision on the ground that the analytical procedures available under Chapter X had in fact been carried out by the Trustee in the preceding Chapter X proceedings; the court was convinced that there was no need for further independent investigation; and no possible benefit could accrue to the general public, general creditors, or secured creditors by further investigation. Here, on the other hand, we have no such assurance or conviction. (4) Finally, in the Wilcox-Gay case, In re Wilcox-Gay Corp., D.C., 133 F.Supp. 548, 551, the debtor corporations were wholly owned by the creditors of the corporations, and the "outstanding securities of the debtor corporations have no present book value." There has been no testimony to the effect that the securities of the corporation in this case are without book value, and certainly the proposed arrangement here does not contemplate putting the control of the company in the hands of creditors, as did the arrangement in the Wilcox case.

'In re Transvision, Inc., 2 Cir., 217 F.2d 243, certiorari denied S. E. C. v. Transvision, Inc., 348 U.S. 952, 75 S.Ct. 440, 99 L.Ed. 744, involved no disturbance of the creditors' priority rights, and the plan affected trade and com-

mercial creditors only. More important, that decision antedated the Supreme Court's decision in General Stores.'

[10] Just as section 146(2) of Chapter X [11 U.S.C.A. § 546(2)] explicitly provides that that chapter may not be used where 'adequate relief' would be obtainable under Chapter XI, so the United States Realty and General Stores cases hold that Chapter XI may not be resorted to where the relief and procedures available only under Chapter X are more appropriate for the protection of the public and private interests involved.

Chapter XI contains no provisions dealing with the rights of secured creditors or of stockholders and no provisions for notice to such parties of the various steps in the proceeding.

Where a referee confirmed an arrangement altering the rights of secured creditors, the order confirming the arrangement was vacated. In the Matter of Camp Packing Company, D.C.N.D. N.Y., 1956, 146 F.Supp. 935. Similarly, a Chapter XI proceeding was dismissed where it involved a transfer of all of the debtor's assets and affected the rights of stockholders. In re May Oil Burner Corporation, D.C.D.Md. 1941, 38 F.Supp. 516.

[11] In neither Chapter X nor Chapter XI is there any definition or classification that would enable the Court to say 'that a corporation is small or large, its security holdings few or many, or that its securities are "held by the public," ' so as to place the debtor exclusively under one chapter rather than the other. Securities and Exchange Commission v. United States Realty & Improvement Co., supra, 310 U.S. 447, 60 S.Ct.

1049. The question is one of propriety 'in the circumstances,' giving due weight to 'the public policy' of the two chapters, their 'legislative history,' their 'terms,' the comparative powers of the court under the two chapters, and the comparable adequacy of the relief and safeguards available under the two chapters.

[12-23] The problem is not one of absolutes. The approach is not monolithic. It is pluralistic—evaluating the aggregate of circumstances in accordance with the guiding criteria expounded by the Supreme Court. Some of the pertinent questions are, for example: Who should control the administration of the debtor's estate and formulate plans for its rehabilitation? Should the features of speed and economy give way to the considerations of thoroughness and disinterestedness? Is there need for an independent study of the debtor's affairs by court or trustee? Is it desirable that advice be given to creditors with respect to their rights or interests in advance of their consent to a plan or arrangement? Is it appropriate that there be restriction on or supervision over the selection and conduct of creditors' committees? Does the situation call for something more than an arrangement of only the rights of unsecured creditors of the debtor, without alteration of the relations of any other class of security holders? Will effective relief probably entail rearranging the capital structure of the corporation or will it involve only a simple composition of debts with unsecured creditors? Will there be any scaling down of the claims of creditors with or without some fair compensating advantage to them which is prior to the rights of stockholders? Will there probably be some readjustment of the

> rights of stockholders? Is it likely that the stockholders will be eliminated, and can this question be answered with any assurance without resorting to the facilities for investigation of the financial condition and structure of the debtor? Is there a serious question of continuing the present management of the debtor?
>
> The answer to no one single question is necessarily decisive. All of the sample questions suggest the breadth of the field to be canvassed. The breadth of the inquiry forecloses a solution by mechanically applying a rigid formula."

The Court then states we should turn to the particular circumstances of the case at bar. As the Court knows, Desert Diet Development Corporation has three stockholders, many purchasers of real estate, and syndicate holders. The purchasers of real estate have received the relief sought by a delivery of the deeds to the trustee herein. This leaves only the rights of "syndicate investors" to be protected. The "syndicate investors" have filed suits in the State Courts of Arizona. It is therefore the contention of the Appellant that the petition should be dismissed as the corporation and its creditors do not need the relief provided by Chapter X of the Bankruptcy Act.

CONCLUSION

It is respectfully submitted that under Chapter X of the Bankruptcy Act and the cases as submitted, that the Order of the District Judge and of the Referee be set aside and the involuntary petition filed against the corporation be dismissed.

Dated, Tucson, Arizona,
October 12, 1966.

CLAGUE A. VAN SLYKE,
Attorney for Appellant.

CERTIFICATE OF COUNSEL

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

CLAGUE A. VAN SLYKE.

(Appendix Follows)

Appendix

Appendix

United States Bankruptcy Act:

Section 130. Every petition shall state—

(7) the specific facts showing the need for relief under this chapter and why adequate relief cannot be obtained under Chapter XI of this Act.

Section 141. Upon the filing of a petition by a debtor, the judge shall enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith, or dismissing it if not so satisfied.

Section 143. If the answer of a debtor shall controvert any of the material allegations of the petition, the judge shall, as soon as may be, determine, without the intervention of a jury, the issue presented by the pleadings and enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith and that the material allegations are sustained by the proofs, or dismissing it if not so satisfied.

Section 145. If any issue raised in an answer filed under section 136 or 137 of this Act has, after hearing upon notice to the debtor, creditors, indenture trustees, and stockholders entitled to controvert the allegations of the petition, already been tried and finally determined under the provisions of section 143

or 144 of this Act, such final determination shall be conclusive for all purposes under this chapter.

Section 146. Without limiting the generality of the meaning of the term "good faith", a petition shall be deemed not to be filed in good faith if—

(2) adequate relief would be obtainable by a debtor's petition under the provisions of chapter XI of this Act.